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Commodities as an Asset Class

The exchange of commodities represents one of the earliest forms of trade. Markets for goods such as rice, silk and spices for example have existed for centuries.

Commodities markets today can offer quite appealing opportunities to investors. From inflation-hedging to portfolio diversification, commodities can potentially provide long-term investment benefits and thus have come to play in increasingly prevalent role in many portfolios.

In the following document, we provide a summary of the key fundamental factors that could influence the price outlook for commodities over the next few years. We also include an overview of the key benefits that investing in commodities can provide. Finally, we briefly consider how investors can gain exposure to commodities through commodity exchange traded products (ETPs).

Factors Driving Commodity Prices

Demand from developing economies

Industrial development is resource-intensive. As manufacturing continues to globalise and per capita incomes rise, the emergence of China and other developing economies as major importers of raw materials has led to a structural, upward shift in global demand. China's appetite for commodities is particularly significant because of the country's size and its high rate of investment.

Mismatch between supply and demand

The supply of many commodities is restricted and, ultimately, finite. In recent times, for many commodities, supply has struggled to keep pace with global demand. Production has been constrained by years of underinvestment in exploration, infrastructure and technology. Building new oil rigs, new mines and the infrastructure required to transport commodities around the world takes time. While rising prices over the past ten years has stimulated the development of additional production capacity, in many cases it will be years before this investment translates into substantial new supply. The imbalance in commodity markets could persist for some time.

New and competing purposes

Ongoing developments in technology influence how different commodities are put to use. Materials such as nickel and platinum, for example, are increasingly being used in the production of rechargeable batteries and hydrogen fuel cells. Meanwhile, as awareness of the long-term impact of traditional fossil fuel consumption continues to rise, soft commodities like maize, sugar and wheat are increasingly being used in the production of first generation bio-fuels. These constant changes and competing uses can impact the dynamics of commodity supply and demand and, consequently, the prices at which they trade.

Investment Benefits

Potential hedge against inflation

Inflation can pose a significant risk to investors over time. For example, if the returns on their investments do not keep up with the cost of living, then living standards may decline.

Commodities and other hard assets can provide a hedge against inflation. As the demand for goods and services increases, prices often follow and so too do the prices of commodities used in their production. As a component of inflation, commodities can therefore potentially provide some degree of portfolio protection during periods of inflationary pressure.

Potential source of diversification

Research has demonstrated that price movements in commodities have little relation to price movements in traditional asset classes such as equities and fixed income. Geo-political risks have historically tended to drive this divergence as has weather by causing supply side shocks; indeed, many of the conditions that cause commodity prices to rise, typically have the opposite impact on the prices of many other asset classes.

What's more, during periods of market turmoil, many asset classes have tended to follow the same trend. Different commodities however can exhibit significant divergences in price – silver and cotton for example may not always rise and fall in tandem. Including commodities in a diversified portfolio of equities, fixed income and other assets can therefore potentially improve risk adjusted returns over time and reduce the impact of broader market volatility.

Gaining Exposure through commodity ETPs

Many physical commodities have actively-traded spot markets. However, for most investors, owning physical commodities outright is impractical, costly and generally involves complicated transportation or insurance arrangements. Some commodities can also be difficult or even impossible to store for long periods.

The advent of commodity exchange traded products (ETPs) has provided investors with access to a wide range of commodity returns. For example, physical metal ETPs are backed by the corresponding amount of physical metal stored in vaults/warehouses and enable investors to gain exposure to spot prices. Non-physical commodity ETPs track indices which provide exposure to price movements in futures contracts. Importantly, the listing of metals on regulated stock exchanges ensures that investors can gain exposure without ever having to take actual physical delivery of commodities.

Convenient

Commodity ETPs can be constructed to reflect the returns of either a single commodity or a basket of multiple commodities in a single trade. Exchange traded products trade and settle like shares and can be bought or sold at any time during the trading day.

Transparent

Commodity ETPs either track an index or the spot price of an underlying physical commodity. Each follows a disciplined, rules-based calculation methodology and details of the underlying are published regularly.

Glossary of Terms

Futures (contract)	An agreement where one party will buy and the other party will sell an asset at a predetermined future date at a set price.
Futures indices	Indices which are constructed to replicate the return of a continuous futures exposure, either in respect of a single commodity or a basket of commodities.
Inflation	A sustained increase in the aggregate or general price level in an economy. It is usually reported as an annual percentage increase.
Spot	The price at which a particular asset can be bought or sold at a given point in time.

*For more information about ETPs please visit www.etpedia.com

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etf Securities

ETF Securities (UK) Limited
3 Lombard Street
London
EC3V 9AA
United Kingdom

t +44 (0)207 448 4330
f +44 (0)207 448 4366
e infoUK@etfsecurities.com
w etfsecurities.com